

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

February 4, 2003

Legend:

Individual =

Oldco =

Newco =

Merger Sub =

Newco 2 =

Old Sub =

X =

Y =

Z =

Year 1 =

Year 2 =

m =

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n =

Dear :

This letter responds to your June 27, 2002 request for rulings on certain federal income tax consequences of a proposed transaction on behalf of the above-referenced taxpayer. The information submitted in that letter and in later correspondence is summarized below.

Oldco was incorporated in State X in Year 1. In Year 2, Oldco filed Form 2553, Election by a Small Business Corporation, to be taxed as an S corporation for federal income tax purposes for its fiscal year beginning 1997, and has continuously operated as an S corporation since that time. Oldco has m shares of common stock outstanding, all of which are owned by Individual.

Oldco currently holds assets used in its businesses Y and Z. Oldco also owns n percent of the stock of Old Sub. State X regulatory requirements related to business Y restrict the growth of Oldco's business Z. For that reason, Oldco seeks to separate the two businesses into separate state law entities. To accomplish that goal, Oldco proposes the following transaction ("Transaction"):

- (1) Oldco will cause Newco to be incorporated in State X, as its wholly owned subsidiary.
- (2) Newco will cause Merger Sub to be incorporated in State X, as its wholly owned subsidiary.
- (3) Oldco will transfer all the assets associated with business Z and the stock of Old Sub to Newco.
- (4) Merger Sub will merge with and into Oldco under applicable state law with Oldco being the surviving corporation. On the effective date of the merger ("Merger Date"), all of the Merger Sub stock held by Newco will be converted, pursuant to state law, into stock of Oldco and all of the Oldco stock held by Individual will be converted into Newco stock.
- (5) Newco will file an election to be treated as an S corporation effective as of the Merger Date and will file a qualified subchapter S subsidiary ("QSUB") election for Oldco, also effective as of the Merger Date.
- (6) Also on the Merger Date, Newco will contribute to Newco2, a newly formed State X corporation, cash and the business Z assets in exchange for shares of Newco2 common stock. Newco's stock in Newco2 will constitute all of the issued and outstanding stock of Newco2. Newco will

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file a QSub election for Newco 2, to be effective on the Merger Date.

Section 3.01(29) of Rev. Proc. 2003-3, 2003-1 I.R.B. 133, 115, provides that the Service will not rule on the qualification of a transaction as a reorganization under 368(a)(1)(F). However, the Service will rule on a transaction involving a significant issue that is not clearly and adequately addressed by published authority. In this case, there are significant issues surrounding the S corporation status of the involved entities, and the effect of the transaction on § 1374 assets currently held by Oldco.

In support of the proposed Transaction, the taxpayer has made the following representations:

- (a) The fair market value of the Newco stock received by Individual will be approximately equal to the fair market value of the Oldco stock surrendered in the exchange.
- (b) Immediately following consummation of the Transaction, Individual will own all of the outstanding Newco stock and will own such stock solely by reason of Individual's ownership of Oldco stock immediately prior to the Transaction.
- (c) Individual will preserve the interest in Newco stock received in exchange for Oldco stock within the meaning of section 1.368-1(e).
- (d) Newco has no plan or intention to issue additional shares of its stock following the Transaction.
- (e) Immediately following the Transaction, for federal income tax purposes, Newco will possess the same assets and liabilities (except for assets used to pay expenses incurred in connection with the Transaction) as those possessed by Oldco immediately prior to the Transaction. Assets used to pay expenses will constitute less than one percent of the net assets of Oldco.
- (f) At the time of the Transaction, Oldco will not have outstanding any warrants, options, convertible securities, or any other type of right pursuant to which any person could acquire stock in Oldco.
- (g) Newco has no plan or intention to reacquire any of its stock issued in the Transaction.
- (h) Newco has no plan or intention to sell or otherwise dispose of any of the assets of Oldco acquired in the Transaction, except for dispositions made in the ordinary course of business.
- (i) The liabilities of Oldco assumed by Newco and any liabilities to which the transferred

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assets of Oldco are subject were incurred by Oldco in the ordinary course of its businesses.

(j) Following the transaction, Newco will continue the historic business of Oldco or use a significant portion of Oldco's historic business assets in the continuing business.

(k) Oldco, Newco and Individual will pay their respective expenses, if any, incurred in connection with the Transaction.

(l) Oldco is not under the jurisdiction of a court in a Title 11 or similar case within the meaning of section 368(a)(3)(A).

Based solely upon the information and representations set forth above, we hold as follows:

- (a) The Transaction qualifies as a reorganization under § 368(a)(1)(F) of the Code.
- (b) No gain or loss will be recognized by Oldco upon the transfer of its assets and related liabilities to Newco in exchange for Newco common stock. (§ 361(a)).
- (c) Newco will not recognize any gain or loss on the receipt of the assets of Oldco, in each instance, in exchange for voting shares of Newco. (§1032(a)).
- (d) The basis of the Oldco assets in the hands of Newco will be the same as the basis of those assets in the hands of Oldco immediately prior to the Transaction. (§362(b)).
- (e) Newco's holding period for the assets it acquired from Oldco will include the period during which such assets were held by Oldco. (§ 1223(2)).
- (f) The basis of the Newco shares (including fractional share interests, if any) received by Individual will be the same as the basis of the Oldco shares surrendered in exchange, therefor. (§ 358(a)(1)).
- (g) The holding period of the Newco shares (including fractional share interests, if any) received by Individual in exchange for Individual's Oldco shares will include the period during which the exchanged Oldco shares were held, provided that the Oldco shares are held as a capital asset in the hands of Individual on the date of the exchange. (§1223(1)).
- (h) Section 1374(d)(8) will not subject the assets that are transferred from

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Oldco to Newco (and from Newco to Newco 2) to the built-in gain provisions of § 1374, but, to the extent that Oldco's assets are presently subject to the built-in gain provisions of § 1374, they will continue to be subject to the built-in gain provisions of § 1374 on the same basis as they were subject to such provisions in Oldco. For purposes of § 1374, Newco's 10 year recognition period begins on the first day Oldco was an S corporation.

- (i) The taxable year of Oldco does not close on the date of the reorganization and such tax year continues in the name of Newco. Treas. Reg. § 1.381(b)-1 and Rev. Rul. 57-276, 1957-2 C.B. 126.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

A copy of this letter must be attached to any income tax return to which it is relevant.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Marlene Oppenheim

Marlene Oppenheim
Senior Counsel, Branch 2
Office of Associate Chief Counsel
(Corporate)